

*Written Testimony of*  
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*Submitted to the*  
**U.S. Department of the Treasury**  
**Advisory Committee on the Auditing Profession**  
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Thank you very much for inviting The Corporate Library to provide input regarding the important issue of *Competition, Concentration, Independence and Other Professional Standards in the Audit Profession*.

The Corporate Library was founded in 1999 by Robert A.G. Monks and Nell Minow. The Corporate Library's products and services fulfill its mission of enabling our clients to enhance value and profitability by improving performance, minimizing risk and increasing accountability, by providing access to its independent corporate governance research and analysis. We actively promote the importance of the transparency of information presented by US companies because we believe that better transparency permits better oversight and decision-making by investors. In fact, our founders have spent their careers establishing and fighting for the rights and responsibilities of investors, and transparency is required for these rights and responsibilities to be exercised effectively.

I have been a Senior Research Associate at The Corporate Library for 2 ½ years, having previously worked in corporate governance and compensation research at a large human resources consulting firm. In addition, I should mention that I began my career at Arthur Andersen, in Los Angeles. I spent four years in Arthur Andersen's tax practice before moving to Michigan to begin an MBA program in 1998. I have very fond memories of my time at Andersen and I greatly appreciate the professional and technical skills I learned during my tenure there.

I strongly agree with the following over-arching principles set forth in the Advisory Committee's Working Discussion Outline:

- ◆ "The audit process and audits should contribute to investor confidence in financial statements by ensuring that the financial statements are reliable, complete and timely."
- ◆ "The audit process and audits should contribute to the transparency of financial reporting for preparers and investors."

I hope that the information from The Corporate Library presented here today will help the Advisory Committee with the execution of its goals based on these important principles.

#### Findings from The Corporate Library's Audit Landscape Report

In August 2007, my colleague, Paul Hodgson, Vice President and Senior Research Associate at The Corporate Library, published a comprehensive report examining the audit profession over the last six years. The report includes information on the fees US public companies have paid outside auditors as well as the share of the US market held by auditing firms. For the purposes of this discussion, I will focus on the findings related to the trends in market share among audit firms in the US over the last six years.

To set the stage, the following is a brief background on the audit landscape based on the introduction to the report written by my colleague, Beth Young, Vice President and Senior Research Associate at The Corporate Library.

*“The past six years have seen tremendous change in the auditing profession as audit firms and their clients have adjusted to new expectations and a changed regulatory environment. The idea of the audit as the loss leader – a ‘commodity to be purchased as cheaply as possible,’ in the words of one regulator – fell into disrepute as investors made clear the value derived from rigorous and conflict-free financial statement audits.”*

*“With the indictment and collapse of Arthur Andersen in 2002 as a result of the Enron accounting scandal, the consolidation of the accounting industry has continued. In the 1970s and 1980s, there were eight major accounting firms. In 1989, Ernst and Whinney merged with Arthur Young & Co., and Deloitte Haskins & Sells merged with Touche Ross & Co., reducing the Big Eight to the Big Six. The 1998 merger of Price Waterhouse and Coopers & Lybrand produced the Big Five.”*

In the Audit Landscape report, The Corporate Library presents analyses of the Big Four firms which remained after Arthur Andersen departed the market – Deloitte & Touche, Ernst & Young, KPMG Peat Marwick and PricewaterhouseCoopers – and also identifies the non-Big-Four firms with clients among the companies studied. A portion of the study is based on a matched sample of 1,293 companies for which we had data for 2001 through 2006, and therefore it provides a very accurate picture of the changing market share of the audit firms included in the study.

The study presents a clear picture of the concentration of the audit industry and how that has changed over the last six years. Among the 1,293 companies studied in the matched sample, the following is the breakdown of market share based on information filed in proxies by the end of June 2007:

- ◆ Ernst & Young – 27%
- ◆ PricewaterhouseCoopers – 26%
- ◆ Deloitte & Touche – 22%
- ◆ KPMG – 19%
- ◆ Non-Big-Four firms – 5%
- ◆ Seeking new auditor – less than 1%

The percent of companies audited by firms other than the Big-Four/Five<sup>1</sup> has increased over the last six years. In 2001, 2002 and 2003, only 2% of the companies in the matched sample used firms which were not in the Big-Four/Five. In 2004, the percentage increases to 3% and in 2005 and 2006 (as mentioned previously) it is 5%.

Interestingly, the number of non-Big-Four/Five audit firms used by companies in the matched sample has increased dramatically since the early part of the century. In 2001, 2002 and 2003, there were only eight or nine audit firms other than the Big Four/Five which provided audit services to the companies in the matched sample. By 2004, that number had increased to 11, and then it increased again to 20 in 2005. By 2006, there were 22 audit firms other than the Big-Four providing audit services to the companies in the matched sample.

This level of concentration did not change dramatically after the demise of Arthur Andersen upon the narrowing of the audit landscape from the Big Five to the Big Four. In fact, the former Arthur Andersen clients were divided fairly equally

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<sup>1</sup> Since Arthur Andersen is included in the data for 2001, we refer to the Big-Five in 2001 and the Big-Four in subsequent years.

among the remaining large firms. For example, in 2002, among the companies in our study:

- ◆ Deloitte & Touche picked up 56 former Arthur Andersen clients;
- ◆ Ernst & Young picked up 55 former Arthur Andersen clients;
- ◆ KPMG picked up 54 former Arthur Andersen clients; and
- ◆ PricewaterhouseCoopers picked up 36 former Arthur Andersen clients.

There are 22 on-Big-Four firms which have a presence in the marketplace as of information filed in 2007 proxies, among companies in our matched sample. Among these firms, Grant Thornton has the largest market share with 30% of the companies studied, and BDO Seidman is close behind with 28% of companies studied. McGladrey & Pullen serves 6% of the companies studied; it is the only other non-Big-Four firm with more than 3% market share. The other 19 firms each have 3% or less of the market share of the companies in our matched sample.

All of this data tells us that there is a high degree of concentration among auditors. The question is whether or not this is good for the audit process and allows audits to contribute to the transparency of financial reporting and therefore to investor confidence. We think the answer is no.

In our view, investors would be better served if the audit market was not dominated by a few large firms. If there were more “Big” audit firms providing audit services the potential for entrenchment would be lessened. When we evaluate the effectiveness of boards of directors, we take into consideration the level to which management and/or the directors are entrenched and potentially holding too much power or not considering new ways of approaching their business and serving shareholders. The potential for entrenchment is also a risk for auditors.

In fact, while we do not advocate mandatory audit firm rotation for all companies, we have supported a requirement at certain companies which calls for the audit firm or partner to be rotated every few years. This is recommended when the board has a history of tolerating entrenchment, either among its members or among the leadership of the company. If the board has not been able to spot the risks associated with entrenchment in the past, the company may be better off having an audit firm rotation policy in place. We also suggest that all companies provide comprehensive disclosure regarding their policy on rotation of audit firms or partners and their procedures for ensuring auditor independence.

Additionally, we support the harmonization of global accounting standards, as long as such standards continue to require a high level of transparency. All US companies should disclose how they are preparing for the global convergence of accounting standards and related changes. Not only would global convergence of accounting standards allow for more ability to compare financial information across borders, it will also open the auditing market in all countries and provide a more diversified pool from which companies can select an auditor.